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MCI

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ORIGINAL

September 10, 1996

Mr. William F. Caton
Secretary
Federal Communications Commission
Room 222
1919 M Street, N.W.
Washington, D.C. 20554

Re: **Implementation of the Telecommunications Act of 1996: Accounting Safeguards Under the Telecommunications Act of 1996; CC Docket No. 96-150**

Dear Mr. Caton:

Enclosed herewith for filing are the original and eleven (11) copies of MCI Telecommunications Corporation's Reply Comments regarding the above-captioned matter.

Please acknowledge receipt by affixing an appropriate notation on the copy of the MCI Reply Comments furnished for such purpose and remit same to the bearer.

Sincerely yours,

Alan Buzacott
Regulatory Analyst

Enclosure
AB

No. of Copies rec'd 0+13
List A B C D E

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, DC 20554

In the Matter of:	)	
	)	
Implementation of the	)	
Telecommunications Act of 1996:	)	**CC Docket No. 96-150**
	)	
Accounting Safeguards Under the	)	
Telecommunications Act of 1996	)	

MCI REPLY COMMENTS

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September 10, 1996

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SUMMARY

Several provisions of the 1996 Act prohibit Bell Operating Companies (BOCs) or, in some cases, all incumbent local exchange carriers (ILECs) from using their telephone exchange service and exchange access operations to subsidize their competitive ventures. In the Notice, the Commission asked whether it should apply its existing cost allocation and affiliate transactions rules to these competitive activities. The Commission also proposed several modifications that were intended to strengthen its existing rules.

There is widespread agreement that the Commission should apply its cost allocation and affiliate transactions rules to the ILEC activities subject to Sections 260 and 270 through 276 of the Act. Support for comprehensive accounting safeguards is not limited to the ILECs' competitors, but extends to large users and state regulatory bodies as well. These parties emphasize that cost allocation and affiliate transactions rules are necessary because the ILECs continue to have the ability and incentive to cross-subsidize their new competitive activities with revenues from their monopoly local exchange operations.

The ILECs, by contrast, urge the Commission to eliminate accounting safeguards for price cap LECs, or forbear from applying accounting safeguards to LECs that have elected a productivity factor that exempts them from sharing obligations. They assert that price cap regulation eliminates the incentives for carriers to shift costs, and that accounting safeguards are thus redundant.

Price cap regulation of interstate services, however, does not eliminate the ILECs' incentives to shift costs. The low-end adjustment/sharing mechanism in the current price cap regime creates a link between the ILECs' reported costs and regulated rates. Even if sharing were eliminated, the Commission would still have to be able to monitor the BOCs' rate of return. Adjustments to the X-factor and other aspects of the price cap regime will continue to be driven by Commission review of the BOCs' performance, measured by their rate of return. The Commission can only obtain an accurate measure of the BOCs' rate of return if their Part 32 accounts reflect only those costs that are properly allocated to regulated operations.

Consequently, the Commission's existing cost allocation and affiliate transactions rules represent the minimum accounting safeguards that should be applied to the ILECs' new competitive operations. As MCI noted in its initial comments, the public interest clearly would not be served if the Commission adopted safeguards less than those upon which it relied to protect the public interest before passage of the 1996 Act opened the door to BOC entry into competitive markets.

Accordingly, the Commission should reject any proposals to weaken its existing rules, under the guise of "streamlining." The USTA proposals would give the BOCs too much latitude in valuing transactions with their affiliates. Instead, the Commission should implement the modifications to its rules proposed in the Notice.

Pursuant to Section 272(b)(5) of the Act, all transactions between BOCs and the affiliates required by Section 272 must be reduced to writing and available for public inspection. The Commission should reject the contention that the "reduced to writing and

available for public inspection" requirement is addressed by existing rules requiring the filing of CAMs. The affiliate transaction information provided in the BOCs' CAMs is not sufficiently detailed to allow the public to monitor the BOCs' compliance with the Act's nondiscrimination provisions. Instead, the Commission must mandate full access to the BOCs' transaction information.

There is widespread support in the comments for requiring annual audits of the transactions between a BOC and its in-region interLATA telecommunications, interLATA information services, and manufacturing affiliates. MCI agrees with AT&T that the Commission should require that a federal-state audit to determine compliance with Section 272 be conducted every year. As AT&T notes in its comments, "nothing in the Act precludes the Commission from exercising its general authority over accounting matters to require audits annually."

MCI supports many of the guidelines that NARUC has proposed for conducting the federal-state audits required by the Act. The NARUC proposals reflect experience gained in federal-state audits over the past several years, and should be incorporated in the Commission's audit guidelines.

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, DC 20554

In the Matter of:	)	
	)	
Implementation of the	)	
Telecommunications Act of 1996:	)	**CC Docket No. 96-150**
	)	
Accounting Safeguards Under the	)	
Telecommunications Act of 1996	)	

MCI REPLY COMMENTS

I. Introduction

MCI Telecommunications Corporation, pursuant to the Notice of Proposed Rulemaking in the above-captioned docket,[1] hereby submits its Reply Comments. In the Notice, the Commission asked for comment on rules to implement Sections 260 and 270 to 276 of the Telecommunications Act of 1996.[2] On August 26, 1996, 29 parties filed comments. In this reply, MCI responds to comments on the need for comprehensive accounting safeguards, the Commission's proposed modifications to its existing rules, and several other issues.

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[1]Implementation of the Telecommunications Act of 1996: Accounting Safeguards Under the Telecommunications Act of 1996, CC Docket No. 96-150, FCC 96-309, released July 18, 1996 (Notice).

[2]Telecommunications Act of 1996, Pub. L. No. 104-104, 110 Stat. 56. In its comments, MCI refers to the new statute as either "the 1996 Act" or "the Act."

II. Price Caps Do Not Eliminate the Need for Cost Allocation and Affiliate Transactions Rules

There is widespread agreement that the Commission should apply its cost allocation and affiliate transactions rules to the incumbent local exchange carrier (ILEC) activities subject to Sections 260 and 270 through 276 of the Act. Support for comprehensive accounting safeguards is not limited to the ILECs' competitors, but extends to large users[3] and state regulatory bodies as well.[4] These parties emphasize that cost allocation and affiliate transactions rules are necessary because the ILECs continue to have the ability and incentive to cross-subsidize their new competitive activities with revenues from their monopoly local exchange operations.[5]

The ILECs, by contrast, urge the Commission to eliminate accounting safeguards for price cap LECs,[6] or forbear from applying accounting safeguards to LECs that have elected a productivity factor that exempts them from sharing obligations.[7] They assert that price cap regulation eliminates the incentives for carriers to shift costs, and that accounting safeguards are thus redundant.[8]

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[3]GSA Comments at 2.

[4]See, e.g., New York Department of Public Service Comments at 10-11; Public Service Commission of Wisconsin Comments at 6.

[5]See, e.g., LDDS WorldCom Comments at 2-5; Sprint Comments at 1-2.

[6]SBC Comments at 4-5.

[7]Ameritech Comments at 6; NYNEX Comments at 5.

[8]SBC Comments at 6-7.

Significantly, the ILECs' arguments find no support among state regulators, many of whom advocate more stringent accounting safeguards.[9] Because the Commission's cost allocation and affiliate transaction rules determine amounts recorded in accounts subject to separations, effective accounting safeguards are necessary to prevent misallocated costs from being reflected in intrastate rates. Until ILECs have been found to be subject to effective competition for all services in a jurisdiction such that dominant regulation is no longer required, the Commission will need to ensure that separations results are not clouded by inclusion of costs properly allocated to nonregulated activities. Not all states rely on price caps to regulate ILECs, and many of those that do continue to monitor ILEC rates of return for sharing purposes.

The BOCs seek to downplay the link that the low-end adjustment/sharing mechanism in the current price cap regime creates between their reported costs and regulated rates. For example, they attach great importance to the fact that all but one BOC elected the no-sharing 5.3 percent X-factor for the current tariff year.[10] However, this is irrelevant to the Commission's determination of the need for effective accounting safeguards. Under the Commission's current price cap rules, a BOC still has the option of electing, on an annual basis, a productivity offset that will make it subject to either sharing requirements or the low-end adjustment. Thus, BOCs that anticipate large expenditures associated with their entry into competitive markets could revert to a lower

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[9]See, e.g., New York Department of Public Service Comments at 8-10.

[10]See, e.g., NYNEX Comments at 5.

productivity offset that would permit them to "game" their earnings to either lower their sharing obligation or to make themselves eligible for an upward adjustment in their PCIs.

The BOCs also suggest that the possibility that sharing will be eliminated from the price cap regime is enough to justify the elimination of accounting safeguards.[11] Such action would clearly be premature, however, because the Commission has yet to complete its review of the BOCs' performance under price caps and determine the role that sharing mechanisms will play. Although the Commission has established a long term goal of eliminating sharing, the Commission has indicated that it is still strongly considering a price cap plan that incorporates at least two X-Factors, one of which would continue to require sharing.[12]

Even if sharing were eliminated, the Commission would still have to be able to monitor the BOCs' rate of return. As Sprint notes in its comments, "the Commission must continue to examine the X-Factor and evaluate whether profit levels are acceptable."[13] It was after such an evaluation of LEC performance under price caps that the Commission concluded that there was a need for substantial revisions to its price cap rules.[14] Adjustments to the X-Factor and other aspects of the price cap regime will

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[11]See, e.g., NYNEX Comments at 5.

[12]See In the Matter of Price Cap Performance Review for Local Exchange Carriers, Fourth Further Notice of Proposed Rulemaking, CC Docket No. 94-1, September 27, 1995, ¶¶108-128.

[13]Sprint Comments at 18.

[14]In the Matter of Price Cap Performance Review for Local Exchange Carriers, First Report and Order, 10 FCC Rcd 8961.

continue to be driven by Commission review of the BOCs' performance, measured by their rate of return. The Commission can only obtain an accurate measure of the BOCs' rate of return if their Part 32 accounts reflect only those costs that are properly allocated to regulated operations.

The BOCs downplay the link between their reported costs and future adjustments to the price cap index (PCI). In particular, they claim that the adoption of USTA's Total Factor Productivity (TFP) moving average mechanism will eliminate the need for periodic review and revision of the X-factor.[15] The Commission, however, has not decided that it will use USTA's TFP methodology. MCI and other parties have pointed out several weaknesses with USTA's TFP approach.[16] More fundamentally, the Commission will still need to monitor the performance of the BOCs even if it adopts a moving average mechanism for deriving the X-Factor. MCI agrees with Sprint, which stated that "as long as regulation is required, the Commission cannot completely sever the umbilical cord to costs. "[17]

It is true that the Commission stated in the Affiliate Transactions Notice that the adoption of a no-sharing price cap system for AT&T greatly reduced its incentives to shift costs.[18] But the BOCs[19] ignore the fact that the Commission also found that AT&T

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[15]See, e.g., Ameritech Comments at 7-8.

[16]In the Matter of Price Cap Performance Review for Local Exchange Carriers, MCI Reply Comments, March 1, 1996.

[17]Sprint Comments at 18.

[18]In the Matter of Amendment of Parts 32 and 64 of the Commission's Rules to Account for Transactions Between Carriers and Their Nonregulated Affiliates, Notice of Proposed

was subject to competitive pressures that would limit its ability to increase prices as a result of cost shifting.[20] For example, the Commission found that AT&T had often elected to set its prices below the price cap maximums. The BOCs' pricing, on the other hand, reveals the absence of competitive pressures. The BOCs consistently price at or near cap in most baskets.[21] In contrast to the long distance market in 1993, when the Affiliate Transactions Notice was released, competition in the local exchange and exchange access markets is only beginning to develop.

III. "Streamlining" of the Existing Rules is Not Warranted

Parties generally agree that the Commission's existing cost allocation and affiliate transaction rules represent the minimum accounting safeguards that should be applied to the ILECs' new competitive operations.[22] Many parties also agree with MCI that the existing rules need to be strengthened, and support the Commission's proposals to modify its existing accounting safeguards.[23]

Rulemaking, 8 FCC Rcd 8017, 8105 (Affiliate Transactions Notice).

[19]See NYNEX Comments at 7.

[20]Id.

[21]For example, NYNEX is currently pricing at cap in all baskets (Transmittal No. 1159, Tariff F.C.C. No. 40).

[22]See, e.g., GSA Comments at 3; Public Service Commission of Wisconsin at 6.

[23]GSA Comments at 5.

The BOCs, however, complain that the Commission's existing affiliate transactions rules are overly burdensome, and thus contrary to the "letter and spirit" of the 1996 Act.[24] In a similar vein, USTA has advanced a proposal, supported by Ameritech and Bell Atlantic, that would substantially weaken the Commission's existing rules, under the guise of "streamlining."[25] USTA makes no attempt to justify the proposed rule changes, other than to argue that they would "simplify the current allocations" and "reduce some of the regulatory burden" on ILECs.[26]

The Commission should reject these attempts to weaken the existing rules. While the 1996 Act encourages the Commission to reduce regulatory burdens whenever it can do so responsibly, it does not suggest that the BOCs and other ILECs do not need to be regulated. The fact that the Act includes the Section 272 separate affiliate requirements, as well as several other prohibitions against cross-subsidy, makes clear that continued regulation of cost allocation and BOC affiliate transactions is not only permissible but essential. Congress recognized that competition in the interLATA telecommunications, interLATA information services, telecommunications equipment, and other markets would be harmed without comprehensive safeguards.

The USTA proposals would give the BOCs too much latitude in valuing transactions with their affiliates. For example, USTA proposes to eliminate fair market

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[24]See, e.g., BellSouth Comments at 1-2.

[25]USTA Comments at 13-15.

[26]USTA Comments at 13.

value as a valuation technique for asset transfers. Under the current affiliate transactions rules, asset transfers from a BOC to its affiliate are valued at the greater of fair market value or cost, while asset transfers to the BOC are valued at the lesser of fair market value or cost. By eliminating the fair market value test, USTA's proposal would open the door to substantial cost shifting. As the Commission noted in the Joint Cost Order, assets valued at "cost" may bear little resemblance to the asset's actual value, such as land and buildings in downtown locations.[27] Under USTA's proposal, local ratepayers would have to make up the difference. USTA's stated rationale, that its proposal would reduce the regulatory burden, is without foundation. Even the BOCs generally acknowledge that a determination of fair market value for asset transfers does not impose undue burdens.[28]

IV. The Modifications Proposed in the Notice are Necessary and Not Unduly Burdensome

In the Notice, the Commission proposed several modifications to its existing affiliate transactions rules. Many parties support these modifications.[29] However, the BOCs, predictably, argue that the proposed rule changes are unnecessary or are unduly "regulatory" and thus contrary to the 1996 Act.

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[27]In the Matter of Separation of Costs of Regulated Telephone Service From Costs of Nonregulated Activities, Report and Order, 2 FCC Rcd 1298, 1336 (Joint Cost Order).

[28]NYNEX Comments at 21-22.

[29]See, e.g., AT&T Comments at 13-14; LDDS WorldCom Comments at 25-28.

In particular, the BOCs oppose the Commission's proposal to require LECs to determine the fair market value of service transactions because, they argue, it would be "exceedingly costly, burdensome, difficult to verify, highly subjective, and against the public interest."[30] The BOCs, however, overstate the complexity of service transactions with the interLATA and manufacturing affiliates required by Section 272. In its reply comments on the BOC In-region NPRM, MCI demonstrated that the "separate employee" provision of Section 272(b) sharply limits the types of service transactions that can occur between the BOC and its interLATA and manufacturing affiliates.[31] If services are shared, either by having one entity perform services for the other or by having a service affiliate perform services in common, the BOC and its affiliate will, in effect, be sharing employees, in violation of Section 272(b). For example, the separate employee provision prevents the BOC from providing administrative services to its affiliate.

The valuation issues to which the BOCs refer in their comments, to the extent they have any validity, are most likely to arise in the context of transactions between a BOC and affiliates established solely to provide centralized services or administrative functions.[32] These intracorporate transactions represent precisely the types of shared services that are limited by the "separate employee" and "arm's length" requirements of the Act.

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[30]NYNEX Comments at 21.

[31]MCI BOC In-Region NPRM Reply Comments at 17-20.

[32]See SBC Comments at 37; NYNEX Comments at 24.

The BOCs also exaggerate the impact of the proposed elimination of prevailing company price as a valuation methodology. The primary effect of the Commission's proposal would be to prevent LECs from automatically valuing non-tariffed services and assets at prevailing company price. The automatic use of prevailing company price is open to manipulation by the LEC, given the difficulties inherent in determining whether a substantial portion of an affiliate's production is being provided to a third party. The Commission's proposal would accordingly curtail the use of prevailing company price. It would not, however, prevent the BOCs from considering prevailing company price. As the Commission noted in the Affiliate Transactions Notice, prevailing company price could still be used, under certain circumstances, as an indicator of fair market value.[33]

V. The Public Must Have Full Access to the BOCs' Transaction Information

Pursuant to Section 272(b)(5) of the Act, all transactions between BOCs and the affiliates required by Section 272 must be reduced to writing and available for public inspection. In their comments, the BOCs demonstrate their hostility to this requirement. BellSouth, for example, complains that the "available for public inspection" requirement will "confer an unearned advantage on the competitors of the BOCs and their separate affiliates" and urges the Commission to eliminate this requirement using its forbearance authority under Section 10 of the 1996 Act as soon as possible.[34]

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[33]Affiliate Transactions Notice, 8 FCC Rcd at 8103.

[34]BellSouth Comments at 22-23.

SBC, Ameritech, and PacTel argue that the transaction information that they currently provide in their cost allocation manuals (CAMs) meets the "available for public inspection" requirement.[35] The Commission should reject this contention. The "reduced to writing and available for public inspection," requirement is not addressed by existing rules requiring the filing of CAMs.[36] The affiliate transaction information provided in the BOCs' CAMs is not sufficiently detailed to allow the public to monitor the BOCs' compliance with the Act's nondiscrimination provisions. The public must have access to a detailed description of each asset or service transferred, as well as the price and other terms and conditions of the transfer.

The other BOCs generally argue that they are only required to make transaction documents available at one of their offices.[37] They oppose, for example, the Commission's proposed requirement that the BOCs permit Internet access to transaction information. However, many other parties urge the Commission to mandate effective public access to transaction records via the Internet or require the BOCs to file transaction information with the Commission.[38] At a minimum, the Commission should adopt MCI's proposal that detailed summary information be filed with the Commission and made available on the Internet. This summary information must be more detailed than

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[35]SBC Comments at 45; Pacific Telesis Comments at 18-19; Ameritech Comments at 23.

[36]U S West Comments at 13.

[37]Bell Atlantic Comments at 17.

[38]AT&T Comments at 13, n. 12

that provided in the CAMs, describing each transaction, the transfer price, and the valuation method employed. Interested parties would, of course, still have the right to request complete transaction information from the BOC and to view this information at a public office designated by the BOC.

The Commission must guard against BOC use of confidentiality claims to limit public access to transaction information. The BOCs must not be permitted to use claims "competitive necessity" to delay access to information that, under the plain language of the Act, must be provided to the public.

V. InterLATA Telecommunications Affiliates

There is widespread support for the Commission's proposal to apply its affiliate transactions rules to transactions between the BOCs and their in-region interLATA affiliates.[39] Many parties agree with the Commission that BOC in-region interLATA telecommunications services "present a potential for improper subsidization." Application of the affiliate transaction rules to the BOCs' in-region interLATA affiliates would also be consistent with the Commission's decision in the BOC Out-of-Region Order to apply its cost allocation rules to transactions between the BOCs and separate out-of-region interLATA affiliates.

There is also widespread support for requiring the BOCs' in-region interLATA affiliates to keep their books according to Part 32 of the Commission's rules. The BOCs

[39]U S West Comments at 21; PacTel Comments at 21.

proposal to simply rely on GAAP is inadequate and inconsistent with the interLATA affiliates' status as carriers regulated under Title II of the Communications Act. As AT&T noted in its comments, "the application of the Part 32 rules to the BOCs' interLATA affiliates is necessary to facilitate audit of transactions between the BOC and the affiliate, given the threat of anticompetitive cross-subsidization."[40] Moreover, if the Commission eliminates the separate affiliate requirement in the future, the BOCs will need to be able to merge the accounting records of their exchange and interLATA businesses under Part 32 accounting.

Many parties also recognized that an "affiliate's imputation of access charges cannot be merely an accounting entry on that affiliate's books."[41] MCI, in its reply comments on the BOC In-Region NPRM, showed that the Commission must require the BOC affiliates to file sufficient cost support with their tariffs to make sure that the affiliates' interLATA services cover all imputed access and other costs.[42] Where interLATA telecommunications services are offered as part of a bundled package with nonregulated or local services, the cost support must contain sufficient information to ensure that the other components of the package also fully cover their imputed costs, so that an interLATA telecommunications service price squeeze cannot be disguised as a discount on other services in the package.

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[40]AT&T Comments at 9.

[41]AT&T Comments at 11.

[42]MCI BOC In-Region NPRM Reply Comments at 37-38.

The Commission should note the interrelationship between this docket and the companion docket CC 96-149. In that docket, both NYNEX and Ameritech claimed that the biennial audits required by Section 272 are sufficient to enforce the imputation requirement, and argued that it is unnecessary to scrutinize their interLATA affiliates' tariffs to ensure compliance with the imputation requirement.[43] Yet, in their comments in this docket, they have not noted that enforcement of the imputation requirements is a function of the audits or discussed the scope of the auditor's responsibilities in this regard.

The auditor must, pursuant to Section 272(d)(1), determine whether the company has complied with Section 272 and the regulations promulgated under Section 272, including the imputation requirement. However, the Section 272(d) audit is, by itself, not sufficient to enforce the imputation requirement because it is inherently backward looking. As Sprint notes in its comments, "[i]n the new competitive environment, enforcement after the harm is done is too late."[44]

VI. Audit Requirements

Many parties agree with MCI that the transactions between the BOC and its in-region interLATA telecommunications, interLATA information services, and manufacturing affiliates should be audited every year. Even the BOCs recognize that

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[43]NYNEX Reply Comments on BOC In-Region NPRM at 33; Ameritech Reply Comments on BOC In-Region NPRM at 4-5.

[44] Sprint Comments at 3.

they are still subject to the annual attestation audit required by Section 32.27 of the Commission's rules, although some call for this audit to be conducted every second year, alternating with the federal-state audit required by Section 272(d).[45] However, MCI agrees with AT&T that the Commission should require that a federal-state audit to determine compliance with Section 272 be conducted every year. MCI agrees that "annual audits are necessary because of the inherent difficulties of bringing accounting irregularities to light and acting to correct them in a timely manner."[46] As AT&T notes in its comments, "nothing in the Act precludes the Commission from exercising its general authority over accounting matters to require audits annually."[47]

Many parties also agree with MCI that the first of the biennial audits required by Section 272 should be conducted one year after the affiliates begin operation, if the Commission does not require annual audits. NARUC, for example, states that an "audit should be performed and submitted for the first full fiscal year of operations after the new subsidiary begins provision of services and every second year thereafter."[48]

In its comments, NARUC proposes guidelines for conducting the federal-state audits required by the Act. MCI agrees with NARUC that the audits should be required of all affiliates whose activities, in any way, involve or whose revenues are derived from the services specified in Section 272, including resale. MCI also supports NARUC's

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[45]Ameritech Comments at 25.

[46]AT&T Comments at 12.

[47]Id.

[48]NARUC Comments, Appendix C at 15.

proposals that one audit should be submitted for each of the three services required by Section 272, that each audit should cover the last two years of operations, and that access should be given to all years' working papers with no restriction or time limit placed upon access to prior years' papers. The NARUC proposals reflect experience gained in federal-state audits over the past several years, and should be incorporated in the Commission's audit guidelines.

VIII. Conclusion

MCI requests that the Commission promulgate regulations implementing the accounting safeguards of Sections 260 and 270 through 276 of the Communications Act that are consistent with the above comments and MCI's initial comments.

Respectfully submitted,
MCI TELECOMMUNICATIONS CORPORATION

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September 10, 1996

STATEMENT OF VERIFICATION

I have read the foregoing and, to the best of my knowledge, information, and belief, there is good ground to support it, and it is not interposed for delay. I verify under penalty of perjury that the foregoing is true and correct. Executed on September 10, 1996.

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CERTIFICATE OF SERVICE

I, Stan Miller, do hereby certify that copies of the foregoing "MCI Reply Comments" were sent via first class mail, postage paid, to the following on this 10th day of September 1996.

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